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AUDIT RISK ALERTS

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

State and Local Governmental Developments— 1997

Complement to AICPA Audit and Accounting Guide
Audits of State and Local Governmental Units



NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of state and local governments with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Technical Manager
Professional Standards and Services—Washington

The staff of the AICPA is grateful to the members of the Government Accounting and Auditing Committee for their contribution to this document.

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State and Local Governmental Developments—1997

Industry and Economic Developments

The steady growth of the economy has been favorable to most state and local governments. The trend in recent years toward generally good fiscal conditions will likely continue in 1997. On the revenue side, state tax revenues grew 5.4 percent in fiscal 1996 according to the Center for the Study of the States. This growth was stronger than budgeted for in many states and contributed to year-end balances that were higher than at any time since the early 1980s. Similar trends have been noted in many local governments. Personal income taxes generated the largest gains with increases in sales tax revenues a close second. Going forward, the myriad of complex issues involved in state taxation of electronic commerce will dominate the picture for state revenue agencies. The use of the Internet is exploding, and a number of difficult tax issues will have to be sorted out.

Many state and local governments approved tax cuts during the past year, however, most of the cuts were relatively small. The modest size of the tax cuts reflects a general concern that federal deficit reduction activity could end up shifting costly responsibilities to state and local governments. In addition to federal budget cuts, state and local officials are also concerned about proposed federal tax changes that could have a revenue impact at the state and local level. For instance, there has been much recent discussion in Washington, DC, about a potential cut in the capital gains tax rate. Such a change would likely alter the federal definition of adjusted gross income, to which a majority of state and local governments tie their own income tax. Until these issues are resolved, any new tax cuts enacted in 1997 will probably be small and, state and local officials will likely continue to develop budgets that are conservative.

In the future, it will become more difficult for state and local governments to increase taxes. Voters in several states passed referendums during the November 1996 election making it more difficult for state legislatures to raise taxes. This reflects a trend toward more taxpayer control of the tax levy process.

One of the more significant developments for state and local governments in 1997 will be welfare reform. In the wake of the recently passed Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Public Law 104-193), state and local governments will have to

move quickly to address a wide range of issues to implement sweeping changes in services to poor families and children. The new law eliminates the automatic entitlement to welfare benefits for mothers and children who qualify. Instead, beginning October 1, 1996, states gained broad authority over their own welfare programs, and the form of federal funding was changed to block grants. These changes will shift the entitlement burden to the states and likely have a bearing on the economic outlook and future spending priorities of state and local governments. Although the law provides states with more flexibility to implement policies and provisions that promote self-sufficiency and personal responsibility, it will also challenge state and local governments, particularly in meeting new work participation rates.

Like organizations in the private sector, many governments are scrutinizing their operations and looking for reengineering opportunities. There has also been a trend toward privatizing functions and services that have traditionally been performed by governments. These activities have resulted in deep structural changes for many state and local governments. Auditors should consider the effects of these changes on their consideration of internal control.

Industry Conferences

The AICPA will hold its fourteenth annual National Governmental Accounting and Auditing Update Conference on August 25–26, 1997, in Washington, DC, and again on September 29–30, 1997, in Denver, CO. This high-level conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal awards. It is the premier forum for the discussion of important governmental accounting and auditing developments. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts. The AICPA also offers an annual training program called the National Governmental Training Program. This year's program will be held on October 20–22, 1997, in Phoenix, AZ. It is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing. For more information about the conference or the training program, please call the AICPA CPE Conference Hotline at (800) 862-4272.

Regulatory, Legislative, and Other Developments

Major Changes to Single Audits of Federal Awards

The promise of major change in single audit policy became a reality during 1996. These changes continue to be finalized during the first

half of 1997. Auditors performing audits of federal awards should follow developments in this area closely to ensure that the appropriate guidance is followed. The sections below summarize four key pieces of guidance which have been or are currently being revised for single audits and program-specific audits of federal awards. The latter three, U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the *Compliance Supplement*, and the AICPA Statement of Position, were not completed at the time of publication of this Audit Risk Alert. Information on the status of these documents will be published in the *Journal of Accountancy* and *The CPA Letter* and will be made available on the AICPA Fax Hotline and home page (<http://www.aicpa.org>). See the section of this Audit Risk Alert entitled "References for Additional Guidance" under the heading "AICPA" for further information on the AICPA Fax Hotline and home page.

Single Audit Act Amendments of 1996 (1996 Amendments). On July 5, 1996, President Clinton signed into law legislation amending the Single Audit Act of 1984 (Public Law 104-156), which is effective for fiscal years beginning after June 30, 1996. The 1996 Amendments extend the act's jurisdiction to not-for-profit organizations, raise the dollar threshold for audit coverage to \$300,000 from \$25,000, implement a risk-based approach to identify the major federal programs to be audited, and shorten the audit report due date to nine months after a transition period of two years. The 1996 Amendments are discussed further in a November 1996 *Journal of Accountancy* article entitled "Auditing Federal Awards, A New Approach." A copy of the 1996 Amendments is also available on the AICPA Fax Hotline; dial (201) 938-3787 from a fax machine and select document number 402. The full text of the 1996 Amendments is located on IGnet at <http://www.sbaonline.sba.gov/ignet/> under the listing "Single Audit."

OMB Circular A-133. A revised OMB Circular A-133, applicable only to not-for-profit organizations, was issued on April 22, 1996. Once the 1996 Amendments were passed (see above), it became necessary for the OMB to propose another revision to OMB Circular A-133 to add states and local governments to the scope of the Circular and to comply with certain other aspects of the 1996 Amendments. This proposed revision was issued in the November 5, 1996, *Federal Register* (61 FR 57231) and a final document is expected to be issued before June 30, 1997. The OMB intends to rescind OMB Circular A-128, *Audits of State and Local Governments*, which is the existing regulation governing audits of federal awards for states and local governments once OMB Circular A-133 is issued in final form.

Once finalized, OMB Circular A-133 will establish audit requirements that apply to not-for-profit organizations (including hospitals and colleges and universities) and state, local, and Indian tribal governments, and will be effective for fiscal years beginning after June 30, 1996. Provisions of the revised Circular include the following:

- The threshold for audit is raised to \$300,000 from \$25,000.
- Auditors are required to identify major programs on the basis of a risk assessment, considering prior audit experience, oversight performed by federal agencies and others, and the inherent risk of the program, rather than solely on the basis of federal expenditures. Due to the timing of the issuance of the final Circular and related audit guidance, auditors may want to consider a provision in the Circular that allows auditors to determine major programs solely on the basis of federal expenditures for first-year audits. First-year audits are defined as the first year that an entity is audited under the new Circular or the first year of a change of auditors. As an example, if an auditor has a client with a June 30, 1997, fiscal year-end, the use of the risk-based approach to determine major programs is optional for that year because it would be the first audit under the new Circular.
- Major program coverage is required to be a minimum of 50 percent (or 25 percent for low-risk auditees) of the federal awards expended.
- The required level of testing of internal control over major programs is clarified as being based on auditors' planning for a low assessed level of control risk.
- Guidance is included for conducting program-specific audits covering those situations in which a federal grantor agency has not issued a program-specific audit guide, as well as those situations in which a program-specific audit guide has been issued by the grantor agency.
- Minimum requirements for the Schedule of Expenditures of Federal Awards are provided.
- Guidance is included concerning the following:
 1. Reporting audit findings in a single schedule of findings and questioned costs, which includes a summary of the auditor's results, and findings and questioned costs related to the financial statement audit as well as to federal awards
 2. Thresholds for determining which audit findings should be included in the schedule of findings and questioned costs

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3. Descriptions of what information auditors should include in an audit finding
 4. Required follow-up on audit findings.
- Auditee management is required to provide a corrective action plan for current year audit findings and a summary schedule reporting the status of prior year audit findings.
 - The definition of *nonprofit organization* is revised to include non-profit hospitals.
 - Restrictions are imposed on auditor selection whereby auditors who prepare the indirect cost proposal or cost allocation plan are prohibited from being selected as the auditor if the indirect costs recovered in the prior year are greater than \$1 million in total. This provision is not effective until audits of fiscal years beginning after June 30, 1998.
 - The due date is shortened for submitting reports to nine months from thirteen months, after a two-year transition period. The transition period is for fiscal years beginning on or before June 30, 1998, during which auditees will have thirteen months after the end of the audit period to complete the audit and submit the reporting package. The provision for a cognizant or oversight agency to grant an extension is retained. Also the report submission process is streamlined, including incorporating a data collection form, and expanding the role of the federal clearinghouse.

Auditors should note that the November 1996 proposed revisions to OMB Circular A-133 included two significant changes from the earlier revision concerning the data collection form and audit coverage of indirect cost pools. In summary, the proposal would require auditors to prepare and sign the data collection form, and test and report on the allowability of costs charged to cost pools. Because the final resolution of these issues is unknown at this time, auditors should carefully review the final Circular for any new requirements.

As noted in the preceding paragraphs, the 1996 Amendments are effective for fiscal years beginning after June 30, 1996, and OMB expects to issue the revised OMB Circular A-133 before June 30, 1997. OMB will instruct federal agencies to adopt OMB Circular A-133 in codified regulations within six months after publication of the final OMB Circular A-133 in the *Federal Register* so that it will apply to audits of fiscal years beginning after June 30, 1996. Therefore, the revised OMB Circular A-133 should be followed for audits of years beginning after June 30, 1996. Until such time as OMB publishes the final revision of OMB Circular

A-133, auditors are encouraged to use the November 5, 1996, proposed revision of OMB Circular A-133 for planning purposes.

Last, as a result of the issuance of the 1996 Amendments and revisions to OMB Circular A-133, questions have arisen with regard to the status of position statements issued by the President's Council on Integrity and Efficiency (PCIE). These position statements were originally developed to address issues related to audits conducted under the Single Audit Act of 1984, OMB Circular A-128, and the March 1990 version of OMB Circular A-133. Therefore, with the exception of PCIE Statement No. 4, none of the remaining position statements is applicable to audits conducted under the 1996 Amendments or the new OMB Circular A-133 requirements. (See the section of this Audit Risk Alert entitled "PCIE Audit Committee Guidance" under "References for Additional Guidance" for a listing of all PCIE position statements.)

Upon publication, a copy of the final revision to Circular A-133 may be obtained from the *Federal Register*; the OMB fax information line (202) 395-9068, document number 1133; the OMB home page on the Internet, which is currently located at <http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html>; or by calling or writing the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503, telephone (202) 395-7332.

Compliance Supplement. A revised OMB Compliance Supplement which is currently under development will set forth the material compliance requirements that are to be included in an audit in accordance with OMB Circular A-133. It will cover states, local governments, and not-for-profit organizations. The OMB is expected to issue a Provisional Compliance Supplement before June 30, 1997, to replace the existing Compliance Supplements entitled *Compliance Supplement for Single Audits of State and Local Governments* (issued in September 1990) and *Compliance Supplement for Institutions of Higher Learning and Other Non-Profit Institutions* (issued in October 1991), which are no longer current. It is expected that a notice will be provided in the *Federal Register* of the Provisional Supplement's availability along with a request for public comment. Auditors should use the Provisional Supplement until the public comment process is completed and OMB issues a Final Supplement. OMB anticipates issuing a Final Supplement in 1998.

The most significant changes to the revised Compliance Supplement will include the following:

- A compliance matrix, which provides an overview of the compliance requirements applicable to the programs listed in the supplement
- Replacement of the classifications of general requirements and specific requirements with the following fourteen types of compli-

ance requirements, all of which are covered by the auditor's opinion on compliance:

Activities Allowed or Unallowed
Allowable Costs/Cost Principles
Cash Management
Davis–Bacon Act
Eligibility
Equipment and Real Property Management
Matching, Level of Effort, Earmarking
Period of Availability of Federal Funds
Procurement and Suspension and Debarment
Program Income
Real Property Acquisition and Relocation Assistance
Reporting
Subrecipient Monitoring
Special Tests and Provisions

- Audit objectives and suggested audit procedures for each type of compliance requirement
- Expanded guidance on allowable costs and cost principles, which includes a comparison of the requirements between the common rule, OMB Circular A-87, *Cost Principles Applicable for State, Local, and Indian Tribal Governments*; OMB Circular A-21, *Cost Principles for Educational Institutions*; and OMB Circular A-122, *Cost Principles for Non-Profit Organizations*
- Detailed guidance on how to determine applicable compliance requirements, control objectives, and audit objectives for programs not listed in the Compliance Supplement
- Characteristics of internal control over compliance presented in the format included in *Internal Control—Integrated Framework* (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission

Initially, the Provisional Supplement will include approximately twenty-five federal programs. This is far less than what was included in the Compliance Supplements that are being replaced. However, the OMB has made a commitment to continue working on the Provisional Supplement and to include additional programs in the Final Supplement. As noted above, the OMB will be adding guidance to the Compliance Supplement that instructs auditors on the appropriate steps to take when a program is not included. The Compliance Supplement

will be available from the Government Printing Office (see the section of this Audit Risk Alert entitled "References for Additional Guidance" under the heading "PCIE Audit Committee Guidance" for information on how to contact the Government Printing Office) and the OMB home page on the Internet, which is currently located at <http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html>. Once the Supplement has been issued, more detailed guidance on how to obtain copies will be included in the AICPA's *CPA Letter* and posted on the OMB and AICPA home pages.

AICPA Statement of Position. With the changes described in the preceding three sections, Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and certain sections of the Audit and Accounting Guide *Audits of State and Local Governmental Units* (the Guide) have become outdated. In response, the AICPA is in the process of developing a new SOP that will supersede SOP 92-9 and the sections of the Guide that are outdated. The new SOP is expected to be issued during the summer of 1997 (assuming that the previously described OMB guidance is issued on the dates planned) and will provide auditors of states, local governments, and not-for-profit organizations with guidance on the work performed and the reports issued for audits under the 1996 Amendments, and OMB Circular A-133. It will also include revised simplified illustrative audit reports. The new illustrative simplified reports will include one report on the financial statements, one report that will meet the requirements for reporting on compliance and internal control under *Government Auditing Standards* (GAS; also known as the Yellow Book), and one report that will meet the requirements of the 1996 Amendments and OMB Circular A-133 for reporting on single audits of federal awards.

Status of Interim Compliance Supplements for Housing Agencies and Authorities and Certain Department of Education Programs

Two federal agencies have issued interim guidance to address the unique requirements of certain agency programs. These two agencies are the U.S. Department of Housing and Urban Development (HUD) and the U.S. Department of Education. OMB ultimately plans to include the programs covered by this interim guidance in the OMB Compliance Supplement. However, these programs, with the exception of one HUD program (the Section 8 Program Cluster) and one Department of Education Program (84.010), will not be included in the upcoming issuance of the OMB Provisional Compliance Supplement (see

the preceding discussion) and will be added at a later date. Additional details are discussed below.

Housing Authorities. Interim guidance for agency program requirements (which would otherwise be listed in Part 4 of the OMB Provisional Compliance Supplement) for public and Indian housing (PIH) authorities is contained in the *Public and Indian Housing Compliance Supplement for Annual Audits of Public Housing Agencies and Indian Housing Authorities by Independent Auditors* (PIH Supplement). The PIH Supplement was developed by the HUD Office of Public and Indian Housing and the Office of Inspector General. It was originally issued in May 1995 and reissued in May 1996. The PIH Supplement is available on the HUD Office of Inspector General home page at: <http://www.hud.gov/oig/oigguide.html>, under the listing of "Audit Guides." A copy may be requested by sending a fax to (202) 401-3963.

U.S. Department of Education Programs. In June 1996, the U.S. Department of Education published interim guidance that includes the agency program requirements (which would otherwise be listed in Part 4 of the OMB Provisional Compliance Supplement) for the following programs: (1) 84.010 Title I Grants to Local Education Agencies, (2) 84.011 Migrant Education—Basic State Grant Program, (3) 84.281 Eisenhower Professional Development State Grants, (4) 84.186 Safe and Drug-Free Schools—State Grants, (5) 84.298 Innovative Education Program Strategies, (6) 84.288, 84.291, and 84.290 Bilingual Educations, and (7) 84.041 Impact Aid. The Title I (84.010) program will also be included in the OMB Provisional Compliance Supplement (see the discussion of the Compliance Supplement above). Each of the other programs included in the Department of Education interim guidance will also ultimately be included in the OMB Compliance Supplement. In the interim, audits in accordance with OMB Circular A-133 should use the Department of Education interim guidance as agency program requirements in testing compliance with the requirements of the programs included therein. However, if Title I (84.010) is a major program and none of the other Department of Education programs listed above are major programs, the OMB Compliance Supplement should be used. This Department of Education guidance is currently available on the Internet at the ED/OIG Non-Federal Audit Team home page (<http://home.gvi.net/~edoig/>) under the listing for "Compliance Supplement for ESEA Programs ASCII text format or WP 5.2 format." A copy may also be requested by sending a fax to the ED/OIG Non-Federal Team at (202) 205-8238.

OMB Circular A-21

Auditors involved with audits of federal awards for governmental colleges and universities should be aware that the OMB issued revisions to OMB Circular A-21 in May 1996 (*Federal Register*, May 8, 1996), which are effective for fiscal years beginning after May 8, 1996. The revisions incorporate four cost accounting standards issued by the Cost Accounting Standards Board (CASB) applicable to all sponsored agreements subject to OMB Circular A-21 and extend the applicability of the CASB disclosure statement to universities that receive more than \$25 million in federally funded sponsored agreements. It also amends the definition of equipment; eliminates the use of special cost studies to allocate utility, library, and student services costs (effective for fiscal years beginning on or after July 1, 1998); requires the use of fixed facilities and administrative cost rates for the life of sponsored agreements; establishes cost negotiation cognizant agency responsibilities; clarifies the policy for a change from use allowance to depreciation; adds criteria to interest allowability; and disallows tuition benefits for employee family members for fiscal years beginning on or after September 30, 1998. In performing audits in accordance with OMB Circular A-133, auditors should consider whether organizations subject to Circular A-21 have complied with the CASB Standards and disclosure requirements incorporated therein.

U.S. Department of Education Issues New Drawdown Procedures for Grant Payments

Auditors with clients that receive grants from the U.S. Department of Education should be aware of changes in the procedures for grant payments accounting and reporting. A letter was issued in July 1996, notifying program recipients of the new drawdown procedures to take effect in 1997 between July and September. The fundamental change is that recipients will have to request Department of Education dollars by individual program when drawdowns are made. In the past, recipients were allowed to pool their drawdowns into a single amount without identifying the specific programs being funded. The new procedure may require many recipients to change their internal processes and systems. Auditors should consider this change when testing cash management in conjunction with single audits. Contact Charles L. Coleman, Director of Cash Management, U.S. Department of Education, for further information at (202) 401-1776.

SEC Municipal Bond Disclosure Requirements

In response to concerns about the municipal securities market, the Securities and Exchange Commission (SEC) issued a final rule entitled

Municipal Securities Disclosure that became effective on July 3, 1995 (Section 17, Code of Federal Regulations (CFR), Part 240, Release No. 34-34961). The final rule amends Rule 15c2-12 under the Securities Exchange Act of 1934 and attempts to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. Auditors should also be aware that the SEC issued Interpretive Release No. 33-7049 (Section 17, CFR, Parts 211, 231, and 241) *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*. This interpretive release is cited in the above-described final rule as a source of guidance on the disclosure obligations of issuers of municipal securities and is intended to assist municipal securities issuers, brokers, and dealers in meeting their obligations under the antifraud provisions of the securities laws.

As a result of the additional attention on municipal bonds, there is certain to be an increased focus on official statements and, hence, potentially higher exposure for auditors. The Audit and Accounting Guide *Audits of State and Local Governmental Units*, chapter 19, "Association With Financial Statements Included in Official Statements," discusses the requirements of AICPA Statement on Auditing Standards (SAS) No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, Professional Standards, vol. 1, AU sec. 550), and contains guidance for auditors associated with financial statements included in official statements.

Further, the SEC's actions will lead to contractual requirements for issuers that may govern, among other things, required financial information and audit requirements. Therefore, auditors should be alert for potential compliance issues in this area.

Recent IRS Activities

Internal Revenue Service Audits. The Internal Revenue Service (IRS) continues to increase its enforcement activities regarding tax-exempt municipal bonds. Currently, the IRS is reportedly auditing about 150 to 200 targeted municipal bond issues for possible tax law violations. Most of these audits involve questions relating to arbitrage, which is earned in the municipal bond market by investing tax-exempt bond proceeds in higher yielding obligations and is prohibited in certain cases. The IRS is also beginning a random audit program to determine the overall level of compliance in municipal bond offerings. If the IRS determines that municipal bond issuers did not comply with laws and regulations, the IRS will likely work with the issuers to reach a settlement. However, if such a settlement cannot be reached, the IRS has the authority to tax bondholders on their interest earnings.

One of the abuses that the IRS has recently been targeting is yield-burning. This is the purchase by a governmental issuer of securities for an advance refunding escrow at artificially inflated prices. If the price of a security increases, the yield decreases—hence the term *yield-burning*. Yield burning may be done without the knowledge of the issuer by others involved in the transaction. Nonetheless, the issuer is the one responsible under current tax laws. Revenue Procedure 96-41, *Compliance With Tax-Exempt Bond Arbitrage Requirements*, was issued by the IRS in mid 1996 as a possible remedy for yield burning in advance refunding escrows. Recently, however, the IRS has stated that it is considering withdrawing the procedure because many issuers have indicated that it is doubtful that they would utilize this remedy. Because of the IRS interest in yield-burning, issuers should examine past advance refundings. If open market securities were used to fund an escrow (as opposed to state and local government securities), the yield on the escrow is slightly below the bond yield, and the securities were not purchased using a legitimate bidding process, yield-burning may have occurred. Auditors should consider suggesting that bond counsel be consulted in such cases.

The calculation of arbitrage rebate, as well as other aspects of arbitrage law, are complex and continue to be an area of concern for all entities that issue tax-exempt debt. Because a violation in the calculation of arbitrage rebate could result in a liability, auditors should become familiar with the arbitrage rebate regulations issued by the IRS and the regulations for calculating rebate earnings in connection with the accounting for bond proceeds, refunding issues, and proceeds that are commingled with other funds for investment purposes. Regulations regarding the calculation of arbitrage rebate, as well as other aspects of arbitrage law, can be found in Section 148 of the Internal Revenue Code (IRC). Due to the complexity of this area, increased audit scrutiny may be warranted on arbitrage rebate liability computations.

With respect to compliance matters, paragraph 11.34 of the Guide states that auditors should consider obtaining evidence that governmental entities have complied with the provisions of indentures and agreements relating to indebtedness, particularly on the use of proceeds, including any restrictions on the use of those proceeds before expenditure for their intended purpose.

Section 403(b) Tax-Sheltered Annuities. Certain governmental entities offer Section 403(b) tax-sheltered annuities to their employees. The IRS has developed an examination program for employers that offer these annuities. To date, examinations have uncovered many deficiencies in employers' plans. These deficiencies have included exceeding the various contribution limits, noncompliance with distribution require-

ments, inadequate salary reduction agreements, and failure to offer universal availability of salary reduction programs (due to impermissible eligibility restrictions, mandatory contributions, and participant exclusions). Sizable assessments against these employers have been common as a remedy to prevent the programs from being declared taxable. Auditors should be alert to potential liabilities and compliance problems in this area, especially since the IRS has recently confirmed that it will be auditing governmental entities.

The IRS's Tax-Sheltered Annuity Voluntary Correction (TVC) program, which began in 1995, gives plan sponsors of Section 403(b) annuity plans the opportunity to voluntarily correct any plan defects. The program was scheduled to conclude October 1996. However, the IRS has recently announced that the program has been extended until December 31, 1998. Use of the TVC program may result in significantly reduced settlements with the IRS, compared to assessments based on deficiencies discovered during audits performed by the IRS.

Classification of Employees Versus Independent Contractors. Many governments, in their efforts to reengineer and streamline operations, are using independent contractors more frequently. Auditors should be aware that the IRS has identified *employee-independent contractor* classification as an area with significant compliance problems. In 1988, the IRS began a nationwide Employment Tax Examination Program to increase compliance by requiring organizations, including state and local governmental entities, to treat misclassified independent contractors as employees subject to withholding taxes. Employers classifying workers as employees must withhold federal income and Social Security taxes (including Medicare) from employees' pay and match the Social Security and Medicare taxes. Further, the reclassification of a worker from an independent contractor to employee for federal purposes is likely to cause a similar reclassification for state tax purposes. Auditors should be alert to such misclassifications by employers, which can result in compliance problems and potential tax liabilities.

There were three significant developments in this area during 1996. First, the IRS issued guidance to its agents regarding worker classification. This guidance provides practical instruction to IRS agents to help resolve questions regarding who is an employee and who is an independent contractor. Auditors should encourage their clients to consider this IRS guidance when making worker classification decisions. Second, the Small Business Job Protection Act of 1996 (Public Law 104-188) modified Section 530 of the Revenue Act of 1978, a relief provision sometimes invoked to enable individuals who are really employees to continue to be treated as independent contractors without consequence to employers. The changes made to Section 530 were generally

favorable. Last, the IRS introduced a Classification Settlement Program to provide a streamlined tax settlement for situations in which Section 530 relief is not available (meaning that its requirements are not met), but an employer has at least consistently reported the affected individuals as independent contractors. In such a case, a reduced tax assessment may be available. This program is currently scheduled to be open for two years, beginning March 5, 1996.

IRC Section 457 Deferred Compensation Plans

Many state and local governments have established deferred compensation plans for their employees under the provisions of IRC Section 457. The recently passed Small Business Job Protection Act of 1996 includes a provision that will require these plans to hold all assets in trust for the exclusive benefit of participants and their beneficiaries. This new requirement generally is effective for assets and income held by IRC Section 457 plans on or after August 20, 1996. However, for plans in existence before August 20, 1996, a trust need not be established before January 1, 1999.

Before this new legislation, the amounts deferred under an IRC Section 457 plan were legally the property of the governmental employer, subject only to the claims of the employer's creditors. Governmental Accounting Standards Board (GASB) Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted Under Provisions of Internal Revenue Code Section 457*, is based on this premise and, therefore, it generally requires that IRC Section 457 plans be displayed in an agency fund. Because the guidance in GASB Statement No. 2 was based on the Internal Revenue Code in effect at that time, the GASB has added a project to its technical agenda to amend GASB Statement No. 2 to adapt it to the new legislation. Auditors should be alert for guidance from the GASB in this area. In the meantime, if a governmental employer establishes a new plan or decides to set up a trust for an existing plan that would be subject to the new law, auditors should refer to GASB Statement No. 2, paragraph 3, which states that GASB Statement No. 2 does not apply to plans in which the deferred amounts are not required to be considered assets of the employer government and are not subject to the claims of the employer's general creditors.

Financial Assurance Mechanisms for Local Government Landfills

Auditors should note that the U.S. Environmental Protection Agency (EPA) recently issued final regulations on the financial assurance provisions for local government owners and operators of municipal solid waste landfill facilities (*Federal Register*, November 27, 1996). The EPA

rule allows local government landfill owners and operators that meet certain financial, public notice, and record keeping and reporting requirements to use a financial test to demonstrate financial assurance for closure, postclosure, and corrective action cost up to a specified maximum limit. If a local government meets the financial test, it must also place in an operating record the following:

- A certification by the local government's chief financial officer that the local government satisfies the requirements of the financial test
- Independently audited year-end financial statements for the latest year prepared in conformity with generally accepted accounting principles (GAAP), including an unqualified opinion by the independent auditor
- A report by an independent CPA or appropriate state agency based on performing a agreed-upon procedures engagement relative to the local government's financial ratios required by the EPA rule

Airport Revenue Diversion

Auditors of public airports should be aware that the Federal Aviation Administration (FAA) issued a notice of proposed policy entitled *Policy and Procedures Concerning the Use of Airport Revenue* (*Federal Register*, February 26, 1996). More recently, the FAA issued a supplemental notice of proposed policy under the same title (*Federal Register*, December 18, 1996) to address additional issues that were raised in the comments received on the February notice. The proposed policy relates to federal grants received by public airports under the Airport Improvement Program (AIP). Among other things, the AIP requires that revenue generated by a public airport is to be expended for the capital or operating costs of the airport. The proposed policy is being issued to alleviate confusion by airports as to how to define the term *airport revenue* and also in response to reports that certain airports have appeared to be diverting revenue in ways that are not lawfully permitted. The proposed policy defines airport revenue and *revenue diversion* and discusses the permitted and prohibited uses of airport revenue and the procedures for monitoring compliance with the revenue use requirement.

The proposal indicates that the FAA will be amending the OMB Compliance Supplement to address the use of airport revenue. However, auditors should be aware that the proposal also states that even though the policy statement is not yet effective, public airports should assume that the FAA would act consistently with the views expressed in the documents in any enforcement action for revenue diversion.

Audit Issues and Developments

Investment Policy Compliance

Investment activity for governmental entities is generally governed by legal or contractual provisions and, in many cases, governments are precluded from purchasing certain investments, including derivatives. These legal provisions include those arising from constitutions, charters, ordinances, resolutions, governing body orders, and intergovernmental grant or contract regulations. Auditors should be aware that in response to the highly publicized investment problems encountered at various governments, many state and local governments have recently passed legislation regarding investment policies and/or the kinds of investments that are allowable.

SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), requires an auditor to consider laws and regulations that, if noncompliance occurs, could have a direct and material effect on the financial statement amounts. *Government Auditing Standards* also requires auditors to test and report on compliance with laws and regulations. Since many governments are legally precluded from purchasing certain investments, auditors should be alert to possible violations of laws and regulations in this area. The Audit and Accounting Guide *Audits of State and Local Governmental Units*, states in paragraph 7.25, that auditors should consider performing procedures, as appropriate, relative to whether there is compliance with the following:

- Legal or official authority for all depositories and investments
- Laws, regulations, and investment policies governing the deposit, investment, and collateralization of public funds

Going Concern

Although it is generally believed that governmental entities will continue as going concerns because of their ability to raise revenues to meet obligations, this is not always the case. Taxpayer initiatives and limitations due to the lack of taxpayer resources have placed limits on some governments' taxing power. In addition, many special-purpose governments do not have the power to raise fees or taxes without the support of some other governmental body. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), and the Audit and Accounting Guide *Audits of State and Local Governmental Units*, paragraphs 17.08 through 17.13, provide guidance concerning the auditor's consideration of an entity's ability to continue as a going concern.

A more frequent occurrence in a governmental environment is for an auditor to conclude that a government will likely continue as a going concern, even though the government is experiencing financial difficulties. In this situation, auditors should consider the need for disclosure of the financial difficulties in the government's financial statements.

Recent Auditing Pronouncements Issued

SAS No. 80. In December 1996, the AICPA Auditing Standards Board (ASB) issued SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The Statement amends SAS No. 31 to recognize that evidential matter may exist only in electronic form. It also provides guidance to auditors engaged to audit the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically. SAS No. 80 recognizes that, in certain entities, some of the accounting data and corroborating evidential matter are available only in electronic form. Source documents such as purchase orders, bills of lading, invoices, and checks might be replaced with electronic messages. In image-processing systems, source documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. SAS No. 80 also states that, in entities in which significant information is transmitted, processed, maintained, or accessed electronically, the auditor may determine that it is not practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. For example, the potential for the improper initiation or alteration of information to occur and not be detected may be greater if information is produced, maintained, or accessed only in electronic form. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his or her report. SAS No. 80 is effective for engagements beginning on or after January 1, 1997.

SAS No. 81. In December 1996, the ASB issued SAS No. 81, *Auditing Investments*, which supersedes AU sec. 332, "Long Term Investments," which was included in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 332). The Statement revises the guidance on auditing assertions about the valuation of investments, including guidance on auditing investments carried at cost and fair value. This guidance will be particularly useful to auditors of governmental entities with the recent issuance of GASB

Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, that will require many investments to be carried at fair value (see the separate discussion of this Statement in the section of this Audit Risk Alert entitled "Accounting Issues and Developments"). SAS No. 81 is effective for audits of financial statements for periods ending on or after December 15, 1997, with early application permitted.

SAS No. 82. In February 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The new Statement will supersede SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). SAS No. 82 provides auditors with expanded guidance on the consideration of fraud in conducting a financial statement audit. It strengthens the auditor's ability to fulfill his or her responsibility to plan and perform the audit in order to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

The new Statement describes the types of fraud and requires auditors to specifically assess the risk of material fraud in every audit. It also provides separate categories of risk factors for fraudulent financial reporting (management fraud) and misappropriation of assets (theft) that require auditor consideration.

In addition, the new Statement provides procedural guidance and examples of how auditors can respond to the presence of fraud risk factors. The new Statement reaffirms the requirement that auditors communicate known instances of fraud to the appropriate levels of management and the audit committee and, under certain circumstances, appropriate regulators.

The new Statement is effective for audits of financial statements for periods ending on or after December 15, 1997.

The AICPA is undertaking a major initiative to assist auditors in understanding and implementing SAS No. 82. Implementation efforts include the following.

- A Practice Aid entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, walks auditors through issues likely to be encountered in applying the new SAS to audits, with valuable tools, such as sample documentation. It also provides specific guidance on applying the concepts of the SAS to various industries, including government. To obtain this publication (No. 008883) auditors should contact the AICPA Order Department at (800) 862-4272 or fax a request to (800) 362-5066.

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- A self-study continuing professional education (CPE) course (No. 732045) entitled *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under SAS No. 82* offers intermediate level information in text format and eight hours of recommended CPE. To obtain the CPE course auditors should contact the AICPA Order Department.
 - Helpful guidance about the new SAS, including a press release, speech outline, and a comparison of SAS No. 82 with SAS No. 53, are available on the AICPA's home page at: <http://www.aicpa.org/members/div/auditstd/index.htm>.

Audit Quality

The AICPA and the President's Council on Integrity and Efficiency (PCIE) are involved in a cooperative effort in which Federal Inspectors General (IGs) of government agencies refer to the AICPA Professional Ethics Division audits of entities receiving federal awards that the IGs consider to be of a substandard nature. Also, the PCIE issues periodic reports on the results of IG desk reviews and quality control reviews of work performed by independent auditors. Information gathered during these investigations and reviews about the most common deficiencies can be useful to auditors when undertaking, planning, and conducting audit engagements of entities receiving federal awards. Some of the more common deficiencies include the following:

- Deficient audit reports (incorrect reports on internal control or compliance, not all required information included, incorrect presentation of financial information without proper qualification, improper or missing opinion, incorrect or missing findings, no disclosure of reportable conditions)
- Inadequate working papers (failure to adequately support opinion, no documentation of required procedures such as internal control evaluation, analytical procedures, or subsequent events review)
- Failure to perform all procedures required in agency audit guide or compliance supplement (no compliance testing, no study and evaluation of internal control)

The risks and ramifications to auditors of issuing deficient audit reports or performing inadequate audits are significant. AICPA-required corrective actions and sanctions can include mandatory CPE in specified subjects, mandatory work product preissuance reviews, preclusion from performing quality reviews, and suspension or expulsion from the AICPA and state CPA society. Substandard audit work can

also result in actions by state boards of accountancy such as fines and loss of license or certification.

Financial Statements on the Internet

It has become more common for governmental entities to make information available on the Internet or electronic bulletin boards (electronic sites). Information in electronic sites may include financial statements and other financial information, press releases, and other promotional material. Auditors should be aware that an Interpretation of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), entitled *Other Information in Electronic Sites Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9550) has been issued to address an auditor's responsibility with respect to other information included in an electronic site if the audited financial statements and the independent auditor's report thereon are also included. The Interpretation appeared in the March 1997, *Journal of Accountancy* and was effective upon publication.

The Interpretation concludes that electronic sites are a means of distributing information and are not documents in the sense that the term *documents* is used in SAS No. 8. Therefore, auditors are not required by SAS No. 8 to consider the consistency of information in electronic sites with the original documents or to read other information contained in electronic sites. The Interpretation also addresses the situation in which auditors are asked by their clients to consider information in electronic sites. It advises auditors that such consideration, which might take different forms, is not a service contemplated by SAS No. 8. However, other auditing or attestation standards may apply, for example, agreed-upon procedures.

Auditors should also note that the AICPA issued a nonauthoritative Practice Alert entitled *Financial Statements on the Internet*, which describes the distribution of audited financial statements and the related auditor's report on the Internet and speaks to several concerns for the auditor community. The Practice Alert is available on the AICPA's Fax Hotline at (201) 938-3787, document number 1566, and the AICPA's home page at: <http://www.aicpa.org/pubs/cpaltr/jan97/suppl/prac.htm>.

Modifying Computer Systems for the Year 2000

Many computer systems process transactions based on storing two digits for the year of a transaction (for example, 97 for the year 1997), rather than a full four digits. A significant number of computer sys-

tems based on two-digit years are not programmed to consider the start of a new century, unless they have been recently modified. Systems that process year 2000 transactions with the year 00 may encounter significant processing inaccuracies and even inoperability. The potential impact of the year 2000 problem on governments is that date-sensitive calculations would be based on erroneous data or could cause a system failure. All forms of financial accounting, including interest computations, due dates, pensions, personnel benefits, investments, and legal commitments will be affected. It can also affect record keeping, such as inventory, maintenance, and file retention.

Fixing this problem will likely be a very long, involved, and expensive process for many governments, requiring computer coding changes that will affect millions of lines of program code. Costs specifically associated with modifying software for the year 2000 should generally be charged to expenditure or expense as incurred. It may be advisable for auditors to consider discussing this matter with their clients to determine whether it is an issue and to determine whether the costs incurred to date have been accounted for properly.

Lawyers' Letters

An interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337), was issued in January 1997. The Interpretation entitled *Use of Explanatory Language Concerning Unasserted Possible Claims or Assessments in Lawyers' Responses to Audit Inquiry Letters* (AICPA, *Professional Standards*, vol. 1, AU sec. 9337), addresses a concern that the inclusion of certain explanatory comments in responses by lawyers to audit inquiry letters may result in a limitation on the scope of the audit. The Interpretation appeared in the January 1997 issue of the *Journal of Accountancy* and was effective upon publication.

A number of lawyers include explanatory comments in their responses to audit inquiry letters that are intended to emphasize the preservation of the attorney-client privilege with respect to unasserted possible claims or assessments. These comments might include the following: "It would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving the organization." The Interpretation states that the inclusion of this or similar wording in a lawyer's response does not result in a limitation on the scope of the audit. The Interpretation also reminds auditors of the requirement pursuant to SAS No. 12 to obtain the lawyer's acknowledgment of his or her responsibility to advise and consult with the client concerning financial statement disclosure obligations with respect to unasserted possible claims or assessments.

Pre-Award Surveys

As part of the process of applying for a government grant or contract, state and local governments may be required to submit a written preaward assertion (survey) by management about the effectiveness of the design of an entity's internal control or a portion thereof, together with an auditor's report thereon. An Interpretation of *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA Professional Standards, vol. 1, AT sec. 400), entitled *Pre-Award Surveys* (AICPA, Professional Standards, vol. 1, AT sec. 9400), was issued in February 1997. The Interpretation appeared in the February 1997, *Journal of Accountancy* and was effective upon publication. This Interpretation was issued to clarify that there are certain things that an auditor should not do in conjunction with a client's preaward survey. The Interpretation states that the consideration of internal control in a financial statement audit does not provide a sufficient basis for auditors to issue a report expressing any assurance about the effectiveness of the design of internal control or any portion thereof. Other questions that are answered in the Interpretation include how auditors can report on the design effectiveness of an entity's internal control or a portion thereof, what auditors' responsibilities are if they are requested to sign a form prescribed by a government agency in connection with a preaward survey, and whether auditors can issue reports on an entity's ability to establish suitably designed internal control.

Accounting Issues and Developments

The GASB has issued several new financial accounting or reporting standards applicable to state and local governments. Some of these standards are effective for the first time in 1997. Other standards will not be effective until after 1997; however, the GASB encourages early application. Auditors should determine which standards a state or local government is either required to adopt in the current year or has elected to adopt early.

GASB Statements Effective During 1997¹

Pension Accounting. In November 1994, the GASB issued the following three pension-related Statements:

¹ Note that GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, is not included in this Audit Risk Alert because it was effective in 1996. Auditors should refer to the Statement for further information or the summary that appeared in last year's Audit Risk Alert, *State and Local Governmental Developments—1996*.

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- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
 - GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*
 - GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*.

GASB Statement Nos. 25 and 27 supersede most of the existing standards for reporting pension information in governmental financial reports. GASB Statement No. 25 addresses the information that should be reported for a pension plan, whether the plan (or the public employee retirement system that administers the plan) issues a separate report or is included as a pension trust fund in the financial report of the plan sponsor or participating employer. GASB Statement No. 27 includes reporting requirements for an employer's expenditures/expense for contributions to a pension plan. GASB Statement No. 26 is an interim Statement pending completion of GASB's project on other postemployment benefits and includes the reporting requirements for defined benefit plans that administer postemployment health-care plans. GASB Statement Nos. 25 and 26 are effective for periods beginning after June 15, 1996. GASB Statement No. 27 is effective for periods beginning after June 15, 1997, with early implementation encouraged. The GASB is working on the development of an Implementation Guide that is expected to be issued by mid 1997.

Also, the GASB issued Technical Bulletin 96-1, *Application of Certain Pension Disclosure Requirements for Employers Pending Implementation of GASB Statement No. 27*, in August 1996. The Technical Bulletin clarifies some implementation issues associated with the new pension-related Statements and is effective for years beginning after June 15, 1996 or when a defined benefit pension plan adopted GASB Statement No. 25, if earlier. The provisions terminate when GASB Statement No. 27 becomes effective or when an employer implements GASB Statement No. 27, if earlier.

Securities Lending Transactions. In May 1995, the GASB issued GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, which is effective for financial statements for periods beginning after December 15, 1995. GASB Statement No. 28 establishes accounting and financial reporting standards for securities lending transactions. In these transactions, governmental entities lend their securities to broker-dealers and other entities for collateral—which may be cash, securities, or letters of credit—and simultaneously agree to return the collateral for the same securities in the future.

GASB Statement No. 28 requires governmental entities to report their loaned securities as assets. If cash is received as collateral on the loan, it would also be reported as an asset, along with any investments made with the cash. Securities received as collateral would be reported as assets if the governmental entity is able to pledge or sell them without a borrower default. Liabilities resulting from these transactions should also be reported in the balance sheet. Securities lending transactions collateralized by letters of credit or by securities that the governmental entity does not have the ability to pledge or sell unless the borrower defaults should not be reported as assets and liabilities. GASB Statement No. 28 also requires that the costs of securities lending transactions, such as borrower rebates (interest costs) and agent fees be reported as expenditures or expenses. These costs should not be netted with interest revenue or income from the investment of cash collateral, any other related investments, or loan premiums or fees.

In addition, GASB Statement No. 28 requires disclosure of the source of legal or contractual authorization for the use of securities lending transactions, any significant violations of those provisions during the period, whether the maturities of the investments made with cash collateral generally match the maturities of the securities loans, and summary information about the credit risk associated with the transactions at the balance sheet date. Disclosure of general information about the transactions is required, as well as the carrying amount and market or fair values of underlying securities at the balance sheet date.

GASB Statement No. 28 also provides guidance for classifying securities lending collateral and the underlying securities in the categories of custodial credit risk required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*.

Risk Financing Omnibus. In February 1996, the GASB issued GASB Statement No. 30, *Risk Financing Omnibus*, an amendment of GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, that is effective for financial statements for periods beginning after June 15, 1996, with early application encouraged. For public entity risk pools, GASB Statement No. 30 modifies the method for calculating a premium deficiency, and it requires recognition of a premium deficiency liability and expense for the amount by which the premium deficiency exceeds unamortized acquisition costs. It also requires disclosure in the notes to the financial statements about the type of reinsurance or excess insurance coverage for certain claims costs, and requires presentation of gross, ceded, and net premiums and claims costs in the ten-year revenue and claims development informa-

tion. Furthermore, GASB Statement No. 30 provides that claims development information should be reported consistently on an accident-year basis, a report-year basis, or a policy-year basis. It also allows presentation of additional percentage information.

For entities other than pools, GASB Statement No. 30 includes specific, incremental claim adjustment expenditures/expenses, and estimated recoveries (such as salvage and subrogation) in the determination of the liability for unpaid claims. Also, it requires disclosure of whether other claim adjustment expenditures/expenses are included in the liability for unpaid claims.

GASB Statements Effective After 1997, With Early Application Encouraged

Investments. In March 1997, the GASB issued GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which is effective for financial statements for periods beginning after June 15, 1997, with early application encouraged. For most governmental entities, Statement No. 31 establishes fair value standards for investments in the following:

1. Participating interest-earning investment contracts
2. External investment pools
3. Open-end mutual funds
4. Debt securities
5. Equity securities, option contracts, stock warrants, and stock rights that have readily determinable fair values

However, governmental entities other than external investment pools are permitted to report certain money market investments and *participating* interest earning investment contracts at amortized cost, provided that the investment has a remaining maturity of one year or less at the time of purchase. Also, *nonparticipating* investment contracts (which includes most certificates of deposit) should be reported using a cost-based measure.

Statement No. 31 also establishes fair value accounting and financial reporting standards for all investments held by governmental external investment pools. An exception, however, is that external investment pools are permitted to report short-term debt investments at amortized cost, provided that the fair value of those investments is not significantly affected by the impairment of the credit standing of the issuer or other factors. For that purpose, a pool's short-term investments are those with remaining maturities of up to 90 days.

For defined benefit pension plans and IRC Section 457 deferred compensation plans, Statement No. 31 provides guidance for applying fair value to certain investment transactions.

GASB Interpretations Effective in 1997

Disclosures of Conduit Debt Obligations. In August 1995, the GASB issued GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, which is effective for financial statements for periods beginning after December 15, 1995. This Interpretation provides disclosure requirements for conduit debt obligations. Conduit debt obligations are certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing capital financing for a specific third party that is not part of the issuer's financial reporting entity. Although conduit debt obligations bear the name of the governmental issuer, the issuer has no obligation for such debt beyond the resources provided by a lease or loan with the third party on whose behalf they are issued. The required disclosures include a general description of the conduit debt transactions, the aggregate amount of all conduit debt obligations outstanding at the balance sheet date, and a clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.

Reverse Repurchase Agreements. In January 1996, the GASB issued GASB Interpretation No. 3, *Financial Reporting for Reverse Repurchase Agreements*, which is effective for financial statements for periods beginning after December 15, 1995. The purpose of the Interpretation is to reconcile the differences between certain reporting requirements of GASB Statement No. 3 for reverse repurchase agreements and GASB Statement No. 28 for securities lending transactions. It provides guidance for reporting reverse repurchase agreements balances and transactions among participating funds in investment pools and for disclosing whether the maturities of the investments made with the proceeds of the agreements generally match the maturities of the agreements.

Capitalization Contributions. In February 1996, the GASB issued GASB Interpretation No. 4, *Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools*, an Interpretation of GASB Statement Nos. 10 and 14, that applies to capitalization contributions made to and received by public entity risk pools, both with and without the transfer or pooling of risk. The Interpretation is effective for financial statements for periods beginning after June 15, 1996, with

early application encouraged. GASB Interpretation No. 4 requires entities to report capitalization contributions made to public entity risk pools with transfer of risk as deposits if a return of those contributions is probable. Otherwise, entities should report the contributions as pre-paid insurance (an asset) to be allocated as expenditures/expenses over future periods (not to exceed ten years under certain circumstances) or, alternatively, in governmental funds, as expenditures in the period made. In neither case should entities report those capitalization contributions (or any participation in those pools) as equity interests in joint ventures. Furthermore, entities should continue to report capitalization contributions to public entity risk pools without the transfer or pooling of risk as deposits or reductions of claims liabilities. The Interpretation also provides guidance for public entity risk pools that make capitalization contributions to other pools (such as excess pooling arrangements) in which they participate.

This Interpretation requires public entity risk pools with the transfer or pooling of risk to report capitalization contributions received as liabilities if a return of those contributions is probable. Otherwise, those pools should report the contributions as unearned premiums to be allocated as premium revenue over future periods (not to exceed ten years under certain circumstances). Public entity risk pools without the transfer or pooling of risk should net capitalization contributions with other amounts and report assets or liabilities, as appropriate.

GASB Exposure Drafts Outstanding

Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments. Issued in January 1997, this exposure draft would make sweeping changes to the financial reporting standards for state and local governments. The GASB is expected to issue a final Statement by mid 1998.

Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities. Issued in April 1997, this exposure draft would make sweeping changes to the financial reporting standards for public colleges and universities. The GASB is expected to issue a final Statement by mid 1998.

Accounting and Financial Reporting for Nonexchange Transactions. Issued in March 1997, this exposure draft would establish accounting and financial reporting standards for nonexchange transactions. Nonexchange transactions are those in which a government gives (or receives) value without directly receiving (or giving) equal value in exchange. The GASB is expected to issue a final Statement by mid 1998.

The Financial Reporting Entity: Affiliated Organizations. Issued in December 1994, this exposure draft would establish standards to determine whether an organization should be classified as an affiliated organization and, if so, would establish criteria to determine whether that affiliated organization is a component unit of a primary government's financial reporting entity. The GASB is expected to issue a final Statement by late 1997.

Other Accounting Matters

Accounting for the Costs of Joint Activities. In February 1997, a proposed SOP, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, was cleared for final issuance by the Financial Accounting Standards Board (FASB) and GASB, subject to certain revisions. The proposed SOP would be applied by not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It would require entities to report the costs of all materials and activities that include a fund-raising appeal as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, unless the criteria of purpose, audience, and content, as defined in the SOP, are met. If the criteria of purpose, audience, and content are met, the joint costs of those activities would be allocated and costs that are clearly identifiable with fund-raising, program, or management and general functions would be charged to that cost objective.

The proposed SOP would be effective for years beginning on or after December 15, 1997. The AICPA is in the process of drafting those revisions and expects to issue the final SOP in the summer of 1997.

References for Additional Guidance

AICPA

Publications. The following are some AICPA publications that may be of interest to auditors of state and local governmental units.

- *Audit and Accounting Guide Audits of State and Local Governmental Units* (No. 012056)
- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (No. 008697)
- *Internal Control—Integrated Framework* (No. 990009)—This report was commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to establish a common

definition of internal control that serves the needs of different parties for not only assessing their control systems, but also determining how to improve them; also available as a software package on WordPerfect (No. 990003) to help users identify and report on potential control deficiencies.

AICPA Continuing Professional Education Courses. The AICPA offers continuing professional education (CPE) in the form of both group study and self-study courses. Group study courses include the following:

- Audits of HUD Regulated Lenders
- Audits of HUD-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Compliance Auditing
- Cost Principles for Nonprofit Organizations under OMB Circular A-133
- Governmental Auditing and Accounting Update
- How to Perform an Audit of a State or Local Government
- Solving Complex Single Audit Issues for Government and Non-profit Organizations
- Single Audit Requirements for Nonprofit and Government Organizations
- Workpaper Preparation Techniques for Government and Non-profit Organizations
- Yellow Book: *Government Auditing Standards*

Self-study courses include the following:

- Introduction to Governmental Accounting
- Solving Complex Single Audit Issues for Government and Non-profit Organizations
- Single Audit Requirements for Nonprofit and Governmental Organizations
- How to Perform an Audit of a State and Local Government
- Understanding Federal Audit Policies and Procedures
- Working With the Revised Yellow Book on *Government Auditing Standards*
- HUD Audits: A Comprehensive Guide

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- Governmental Auditing and Accounting Update
 - Introduction to OMB Circular A-87
 - Compliance Auditing
 - Audits of Rural Development and Housing Programs
 - Communicating Material Noncompliance and Internal Control Weaknesses

The following video courses are also available:

- Effective Yellow Book Auditing
- 1997 Government Auditing and Accounting

For more information about AICPA CPE courses, call the AICPA information hotline at (800) 862-4272.

AICPA Home Page. The AICPA has established a home page on the World Wide Web. "AICPA Online," the AICPA's Web site (<http://www.aicpa.org>), offers members a unique opportunity to obtain AICPA and accounting-related material when they need it. CPAs can benefit tremendously by using online resources such as professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, and exposure drafts, among other things. There is also a "Talk to Us" section for members who want to send E-mail messages directly to AICPA representatives or teams. Also, with a comprehensive list of links to other accounting- and finance-related sites, "AICPA Online" serves as a gateway to additional Internet resources.

Fax Hotline. The AICPA has a 24-Hour Fax Hotline that enables members to obtain pertinent information from a fax machine twenty-four hours a day, seven days a week. Current AICPA comment letters, conference brochures and registration forms, CPE information, AICPA Accounting Standards Executive Committee actions, and legislative news are some of the kinds of documents that can be retrieved on the Fax Hotline. To access the hotline, simply dial (201) 938-3787 from a fax machine, follow the voice cues, and when prompted, provide the number(s) of the document(s) desired. A list of all items available through this service may be obtained via the Fax Hotline by entering document number 1.

Governmental Accounting Standards Board

The GASB offers the following publications and services:

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- *Codification of Governmental Accounting and Financial Reporting Standards*, as of June 30, 1996 (GCD96)—An edition as of June 30, 1997, is expected to be issued in late summer 1997
 - *GASB Original Pronouncements*, as of June 30, 1996 (GOP96)—An edition as of June 30, 1997, is expected to be issued in late summer 1997
 - *GASB Implementation Guides*—These question-and-answer special reports are an occasional service containing implementation guidance for GASB standards. To date, the GASB has issued Implementation Guides for GASB Statement Nos. 3, 9, 10, and 14. The GASB is also expected to issue implementation guidance on its Pension Statements (GASB Statement Nos. 25, 26, and 27) by mid 1997.
 - *GASB Home Page*—Information about the GASB can be found on a World Wide Web home page site. The GASB address is <http://www.financenet.gov/gasb.htm>. Items that can be found include "Facts about GASB," summaries of all final GASB documents and of current due process documents, a list of publications, a list of Board members and staff with their E-mail addresses, and the technical plan for the current quarter.
 - *Fax Information System*—The GASB has a twenty-four-hour fax system that enables interested persons to obtain information on upcoming meetings, the current technical plan, and "Facts about GASB." To access the system, dial (203) 847-0700, extension 14 from a fax machine, and follow the voice cues.
 - *GASB Action Report*—This is a monthly newsletter.
 - *Governmental Accounting Research System (GARS)*—This information-based software package allows research on GASB literature.

GASB publications and services can be obtained by calling the GASB Order Department at (203) 847-0700, extension 10.

Federal Agencies—Administrative Regulations

Most federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by the various agencies. The regulations are included in the *Code of Federal Regulations*.

In 1988, a final rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments*, was published, establishing a common rule to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

Auditors should also be aware that many agencies have program-specific and other audit requirements that are not covered by OMB Circular A-133. Such requirements may relate to certain programs (such as student financial assistance or HUD-insured mortgage programs), as well as to contract audit requirements. Auditors may want to refer to the PCIE's *Revised Program Audit Guide Listing* for a summary of federal programs that have separate audit guides (see the section herein entitled "PCIE Audit Committee Guidance" for more details).

General Accounting Office

General Accounting Office (GAO) publications include the following:

- *Government Auditing Standards, 1994 Revision*—These standards, also referred to as the Yellow Book, relate to audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. The standards incorporate the AICPA Statements on Auditing Standards for fieldwork and reporting, and prescribe the additional standards needed to meet the more varied interests of users of reports on governmental audits. These standards are available from the Government Printing Office (GPO), Superintendent of Documents, Washington, DC 20401; telephone (202) 783-3238; telefax (202) 512-2250; Stock No. 020-000-00-265-4.
- *Interpretation of Continuing Education and Training Requirements*—This provides guidance to audit organizations and individual auditors on implementing the CPE requirements of *Government Auditing Standards* (April 1991, 020-000-00250-6). This Interpretation is available from the GPO, Superintendent of Documents, Washington, DC 20401.
- *Assessing the Reliability of Computer-Processed Data*—This guidebook is intended mainly for auditors and evaluators, not for experts in data processing. It provides some guidelines on what auditors must do to satisfy the requirements of *Government Auditing Standards* (September 1990, GAO/OP-8.1.3).

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- *Guide to Federal Agencies' Procurement of Audit Services from Independent Public Accountants*—This booklet provides a basic understanding of how independent public accountant (IPA) contracts should be awarded to officials unfamiliar with federal procurement. It discusses the special requirements of the Chief Financial Officers (CFO) Act (April 1991, GAO/AFMD-12.19.3).
 - *How to Get Action on Audit Recommendations*—This guide is intended to help auditors get more action and better results from their audit work on governmental programs and operations (July 1991, GAO/OP-9.2.1).
 - *Assessing Risks and Returns: A Guide for Evaluating Federal Agencies' IT Investment Decision-making*—This guide provides a structure for evaluating and assessing how well a federal agency is selecting and managing its information technology resources and to identify specific areas where improvements can be made (February 1997, GAO/AIMD-10.1.13).
 - *Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology*—This guide focuses on what agencies can do to improve performance by using new approaches to managing information and their related technologies (May 1994, GAO/AIMD-94-115).
 - *Executive Guide: Effectively Implementing the Government Performance and Results Act*—This guide identifies key steps that agencies need to take towards the implementation of performance measurement, along with practices that can make implementation a success (June 1996, GAO/GGD-96-118).

Unless otherwise noted above, requests for copies of these publications should be sent to the GAO, P.O. Box 6015, Gaithersburg, MD 20884-6015. The telephone number is (202) 512-6000. Orders may also be placed by using the fax number (301) 258-4066. For copies of GAO reports and testimony, the status of GAO's open recommendations, and GAO's audit policy, check the GAO home page at: <http://www.gao.gov>. The GAO home page also contains the electronic version of *Government Auditing Standards*. For information on how to access GAO reports or other documents on the Internet, send an E-mail message to info@www.gao.gov.

Office of Management and Budget

Circulars. OMB issues grants management circulars to establish uniform policies and rules to be observed by federal agencies for the ad-

ministration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing grants management circulars includes due process with a notice of any proposed changes in the *Federal Register*, a comment period, and careful consideration of all responses before issuance of final circulars. Circulars and other documents relevant to audits of state and local governmental units are listed below. For copies of circulars and bulletins, write or call the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; telephone (202) 395-7332 or check the OMB home page at <http://www.whitehouse.gov/WH/EOP/OMB/html/ombhome.html>. An alternate address is <http://www.sbaonline.sba.gov/ignet/>.

OMB Circulars Relevant to Audits of State and Local Governments and Not-for-Profit Organizations

| <i>Circular Number</i> | <i>Applicability</i> | <i>Issue Date</i> |
|------------------------|--|--|
| A-21 (Revised) | Cost principles for educational institutions | May 1996 |
| A-87 (Revised) | Cost principles for state, local and Indian tribal governments | May 1995 |
| A-102 (Revised) | Grants and cooperative agreements with state and local governments | October 1994 |
| A-122 (Revised) | Cost principles for nonprofit organizations | October 1995 |
| A-133 (Revised) | Audits of states, local governments, and non-profit organizations | Revision expected before June 30, 1997 |

OMB Circular A-133 Compliance Supplement. The OMB Compliance Supplement sets forth the major federal compliance requirements that should be considered in an audit of states, local governments, and non-profit organizations that receive federal assistance. It supplements OMB Circular A-133. A revision to the Supplement is expected to be issued before June 30, 1997. For a separate discussion of the Compliance Supplement, see the section of this Audit Risk Alert entitled "Regulatory, Legislative, and Other Developments."

Other Guidance. The *Catalog of Federal Domestic Assistance (CFDA)* is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the American public. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through

the catalog and maintains the information database from which program information is obtained. A searchable version of the CFDA is available on the GSA home page, which is currently located at <http://www.gsa.gov/fdac>.

Program information provided by the catalog includes authorizing legislation and audit requirements. The GSA makes copies available to certain specified national, state, and local government offices. Catalog staff may be contacted at (202) 708-5126. The catalog may be purchased from the GPO by calling (202) 783-3238.

Program information is also available on machine-readable magnetic tape. The tape may be purchased by writing the Federal Domestic Assistance Catalog Staff (WKU), General Services Administration, Ground Floor, Reporters Building, 300 Seventh Street, SW, Washington, DC 20407, or calling (202) 708-5126.

PCIE Audit Committee Guidance

The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

The PCIE Audit Committee (or its predecessors) has issued the position statements listed in the following. These position statements were developed to address issues related to audits conducted under the Single Audit Act of 1984, OMB Circular A-128, and the March 1990 version of OMB Circular A-133. With the exception of PCIE Statement No. 4, none of the position statements are applicable to audits conducted under the Single Audit Act Amendments of 1996 or the April 1996 OMB Circular A-133 (or subsequent versions).

- PCIE Statement No. 1 provides guidance on determining whether a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.
- PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50-percent rule on internal control coverage prescribed in the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* should be accepted.
- PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.
- PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.

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- PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110, *Uniform Administrative Requirements for Grants and Other Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*. This statement is obsolete since it covers issues regarding audits of not-for-profit organizations prior to the issuance of OMB Circular A-133.
 - PCIE Statement No. 6 provides clarifications and additional practical working guidance to Inspectors General and others participating in audits of not-for-profit organizations performed under OMB Circular A-133. It contains questions and answers on OMB Circular A-133 and was developed from questions frequently asked.

PCIE Statement Nos. 1 through 5 are available from the U.S. Department of Education, Office of the Inspector General, Technical and Non-federal Audit Staff, 600 Independence Avenue, SW, Washington, DC 20202-1510; telefax (202) 205-8238. PCIE Statement No. 6 (stock number 041-1-374-6) is available from the GPO, Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328; telephone (202) 783-3238. All PCIE position statements are available on IGnet, the Inspectors General Internet site. The Internet address is <http://www.sbaonline.sba.gov/ignet/>. The position statements are located in the Single Audit Library.

The PCIE has also issued the following:

- *Uniform Desk Review Guide of A-128 Single Audits* (last published in 1991) (PCIE-6-56)
- *Uniform Quality Control Review Guides for A-128 Single Audits* (last published in 1991) (PCIE-6-57)
- *Revised Program Audit Guide Listing* (July 1993) (stock number 065-0-585-9)
- *Study on Improving the Single Audit Process* (September 1993) (stock number 065-0-615-4)

Copies of the *Uniform Desk Review Guide* and the *Uniform Quality Control Guide* are available from the U.S. Department of Education, Office of Inspector General, at the preceding address and telefax number. The *Revised Program Audit Guide Listing* and the *Study on Improving the Single Audit* are available from the GPO at the above address. All of the above documents are also available for download from the Single Audit Library of IGnet, at the preceding Internet address.

Government Finance Officers Association

The address, telephone number, and fax number of the Government Finance Officers Association (GFOA) are 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; phone (312) 977-9700, fax (312) 977-4806, Internet address: <http://www.financenet.gov/gfoa.htm>. GFOA publications include the following:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—The 1994 GAAFR provides detailed professional guidance on the practical application of GAAP to state and local governments. Discussions cover both the implementation of authoritative standards and current practice. Chapters are accompanied by detailed journal entries that tie to a complete illustrative comprehensive annual financial report. Special chapters are devoted to auditing, state governments, and special entities. An extensive glossary and model chart of accounts are also provided, along with both a general index and an index of journal entries. (The *GAAFR Study Guide* is also available to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *The GAAFR Review Guide to GASB Pronouncements*—This book presents edited articles from the GFOA newsletter *GAAFR Review* that cover all of the statements and interpretations issued by the GASB. It also includes relevant articles from the newsletter on the proper application of the provisions of GASB pronouncements.
- *A Preparer's Guide to Note Disclosures*—This guide compiles all current authoritative guidance on thirty-six key disclosure topics for state and local government financial statements.
- *An Elected Official's Guide to Auditing*—This guide provides elected officials, management, and other nonaudit professionals with practical information concerning the audit process for state and local governments.
- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including a model request for proposal), monitoring the audit, and the resolution of audit findings.
- *An Elected Official's Guide to Internal Control and Fraud Prevention*—This booklet explains the nature and purpose of internal controls and how those controls can be made more effective at all levels. It

also presents examples of some of the types of fraud encountered in the public sector.

- *A Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
- *Financial Reporting Series*—This set of books contains information and creative examples of how governments present specific financial reporting information. It includes the following:
 - *Illustrations of Statistical Sections of Comprehensive Annual Financial Reports of State and Local Governments*
 - *Illustrations of Interim Financial Statements of State and Local Governments*
 - *How to Understand Local Government Financial Statements: A User's Guide*
 - *Illustrations of Combined, Combining, and Individual Fund and Account Group Financial Statements of State and Local Governments*
 - *Suggested Solutions to Governmental Accounting and Financial Reporting Practice Problems in Applying Authoritative Standards*
 - *Illustrations of Popular Reports of State and Local Governments*

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This Audit Risk Alert supersedes *State and Local Governmental Developments—1996*.

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Auditors should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1996/97*, which may be obtained by calling the AICPA Order Department at the number below and requesting publication number 022194 (audit) or 060674 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB and GASB publications referred to in this document can be obtained directly from the FASB or GASB by calling the FASB/GASB Order Department at (203) 847-0700, ext. 10.

References to Useful Web Sites

The following listing summarizes the various web sites of many of the organizations referred to in this Audit Risk Alert.

| <i>Organization</i> | <i>Web Site Address</i> |
|---|---|
| AICPA | http://www.aicpa.org |
| FinanceNet | http://www.financenet.gov |
| General Accounting Office | http://www.gao.gov |
| General Services Administration | http://www.gsa.gov |
| Governmental Accounting Standards Board | http://www.financenet.gov/ gasb.htm |
| Government Finance Officers Association | http://www.gfoa.org |
| IGnet | http://www.sbaonline.sba.gov/ ignet/ |
| U.S. Department of Education Office of Inspector General Non-Federal Audit Team | http://www.gvi.net/~edoig/ |
| U.S. Department of Housing and Urban Development Office of Inspector General | http://www.hud.gov/oig.html |
| U.S. Office of Management and Budget | http://www.whitehouse.gov/ WH/EOP/OMB/html/ ombhome.html |

